# In Case You Missed It: CSOP's Weekly China Wrap Up

**Moody's downgrades China's credit rating, upgrades outlook from 'negative' to 'stabile'**

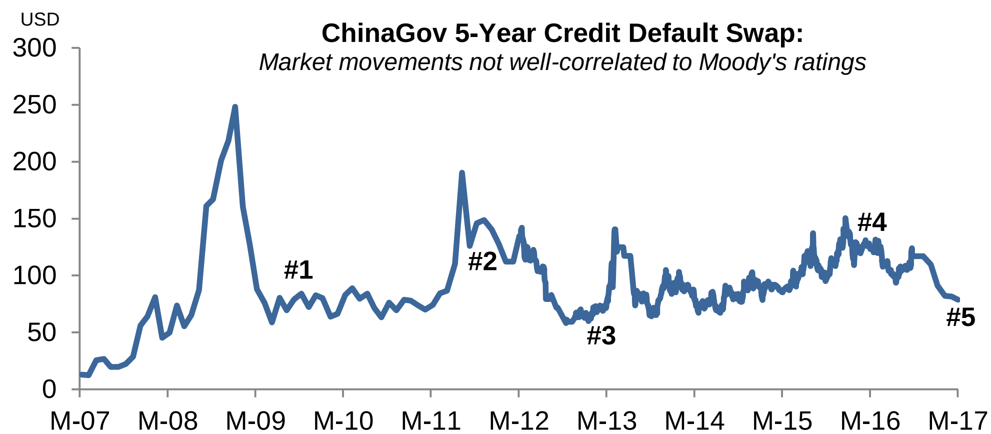
Moody's downgraded China's sovereign credit rating one notch from Aa3 to A1, citing the country's rising debt burden and slowing economic growth as justification. Despite the cut, the agency's economic outlook has otherwise moderated; they upgraded China from 'negative' to 'stable.'

*Does it matter?*

Analysis of the event falls into two camps: "the end is near" and "eh, whatever." Bearish onlookers emphasize that the downgrade is the first since 1989, a period when China analysis was marred by Tiananmen Square-related concerns. Pessimists outline worst-case scenarios in which Moody's action will spur credit downgrades and raise borrowing costs for companies, a chain of events that could harm share prices ahead of MSCI's June 20th decision.

Others, however, appear generally unconcerned, dismissing Moody's ratings as a lagging indicator and somewhat irrelevant. This camp posits that, even with the downgrade, the market has already priced in China's risk profile and the country's debt remains comfortably investment-grade. They liken China to international darling Japan, which also has an A1 rating.

Bank of China International issued one of the loudest rebuttals of the downgrade, arguing that similar ratings actions have historically made limited impact on sovereign debt. This analysis appears well-supported by the market. 5-year China sovereign CDS barely moved from the 78 level after the announcement.[1] Moreover, the last time Moody's downgraded its China outlook to "negative" on March 2, 2017, China's sovereign 5-year credit default swap narrowed from 133.615 to 108.999 in the following three weeks, implying a lower possibility of default.




Source: Bloomberg, as of 5.25.2017.
Note: Lower price implies lower probability of default. Chart subject to change.

*The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles.*

*MOODY'S BOND RATING CATEGORIES: Aaa: Obligations rated Aaa are judged to be of the highest quality, subject to the lowest level of credit risk. Aa: Obligations rated Aa are judged to be of high quality and are subject to very low credit risk. A: Obligations rated A are judged to be upper-medium grade and are subject to low credit risk. Baa: Obligations rated Baa are judged to be medium-grade and subject to moderate credit risk and as such may possess certain speculative characteristics. Ba: Obligations rated Ba are judged to be speculative and are subject to substantial credit risk. B: Obligations rated B are considered speculative and are subject to high credit risk. Caa: Obligations rated Caa are judged to be speculative of poor standing and are subject to very high credit risk. Ca: Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest. C: Obligations rated C are the lowest rated and are typically in default, with little prospect for recovery of principal or interest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions. Non-Rated: These bonds are not rated.*

Events:

1. November 2009: Moody's kept China's A1 rating, upgraded outlook from stable to positive
2. November 2011: Moody's upgraded China's rating from A1 to Aa3, outlook remained positive
3. April 2013: Moody's kept China's Aa3 rating, downgraded outlook from positive to stable
4. March 2016: Moody's kept China's Aa3 rating, downgraded outlook from stable to negative
5. May 2017: Moody's downgraded China's rating from Aa3 to A1, upgraded outlook from negative to stable

**MSCI to announce A-Share decision on June 20, 2017**

MSCI will announce whether it will include A-Shares in its Emerging Market (EM) Index on June 20, 2017.[2,3]

*What does the market expect?*

The index provider surprised investors last June in declining for the third straight year to include mainland China shares in its USD 1.5 trillion EM index.[4] However, market consensus has more bullish this time around because MSCI revised their proposal from 2016 to 2017, considering a smaller universe of equities.

Whereas the 2016 proposal was based on the QFII and RQFII schemes, the new version bases qualification on Stock Connect.[5,6] This revision solves the thorny issues of quota limits and capital repatriation constraints. Whereas only 20% of assets can be repatriated each month under the QFII scheme, Stock Connect is not limited by aggregate quota or capital repatriation constraints.

Moreover, last year's proposal involved an initial A-Share weight of 1.0%. This year's proposal has decreased the weight to 0.5% of the total index. Because international investors using MSCI EM Index as a benchmark could essentially ignore the A-Share weighting without much impact, MSCI seemingly faces fewer obstacles to inclusion.

Finally, international players and China's government alike were less-than-thrilled by last year's rejection. ETF behemoth and major MSCI client BlackRock publically supported A-Share inclusion for the first time.[7]

**China to reportedly resume Qualified Domestic Limited Partnership program**

China will reportedly resume the Qualified Domestic Limited Partnership (QDLP) program, reversing a 2-year ban on the scheme. The State Administration of Foreign Exchange (SAFE) has yet to approve the rule change.

*What is QDLP and why was it suspended?*

Launched in 2013, the QDLP program allows foreign fund managers to raise capital from mainland Chinese high-net-worth individuals to invest overseas. Widely popular, it was long considered one of the only vehicles for Chinese to invest money overseas. However, the program was suspended in 2015 after China's infamous equity market meltdown. The scheme's interruption continued into 2016 amid concerns about capital outflows and decreasing foreign reserves.

*Rationale for resumption*

Officials have expressed relief that capital outflows have recently stabilized and foreign reserves rebounded. The RMB appreciated 1% in 2017 after depreciating 6.5% in 2016 against a strengthening US dollar.[8] Market onlookers had expected that the program would resume given the normalizing environment, but anticipate that each manager's quota allocation will be lowered from USD 100 million to USD 50-75 million due to regulatory caution.

**China planning launch of onshore index options and new futures products, details to be determined**

In a speech at the 14th Shanghai Derivatives Market Forum, vice chairman of the China Securities Regulatory Commission Fang Xinghai announced that authorities are studying plans to commence trading of onshore index options as well as futures for agricultural and industrial commodities. According to Fang, regulators are also evaluating options to permit foreign investors to trade futures and domestic commercial banks to participate in the treasury futures market. Although no further details were provided about the launch schedule or contract size, Fang's news was nonetheless well-received. The CSI300 index rallied 1.80% the day of the announcement.[9]

*A primer on China's domestic futures market*

Prior to 2015, China's equity futures market was the world's largest. However, regulators blamed the derivatives for the mid-2015 crash and imposed strict restrictions on the instruments, effectively killing the market. As a result, shorting stocks remains immensely difficult to this day. Selling a stock more than once a day is prohibited, and borrowing funds to short single names is unduly expensive. Index futures reform is thus crucial for investors seeking to express a bearish view or hedge portfolio exposure. Reformers also point to promising macro-effects. Not only would the instruments help reduce volatility and improve pricing, their presence would be a key step in convincing index providers like MSCI that China's mainland shares are mature enough to merit inclusion in benchmark indices.

*Other proposed changes: foreign and commercial participation*

In addition to the domestic changes, Fang mentioned that the CSRC is studying rules governing foreign investor and commercial bank participation in commodity futures and treasury futures markets, respectively.

**Xi urged to convince Trump of importance of Paris Accord ahead of upcoming G7 summit**

Former top US climate negotiator Todd Stern urged President Xi to persuade Trump against leaving the Paris Agreement on greenhouse gas mitigation. Arguing that "no world leader is more important [than Xi]" in helping to convince Trump, Stern asserted that US withdrawal would be a "serious mistake."

Despite China's less-than-spotless record on environmental conservation, Xi has gotten serious about leading the battle against climate change. Citing a new United Nations report about emissions targets, a recent New York Times article called China's progress "astonishing."

*US falters, China and India move forward*

Citing economic growth and manufacturing competitiveness, the Trump administration has retreated from Obama-era promises to substantially reduce America's greenhouse gas emissions. Trump was slated to discuss climate issues at last week's G7 meeting, though failed to announce a decision on US withdrawal.[10] Because the remaining 6 G7 countries—the United Kingdom, Germany, France, Italy, Japan, and Canada-- have committed to the accord, Trump's outlier status has drawn significant criticism.

In contrast, recent UN-approved research suggests that developing and heavily polluted nations China and India are set to exceed self-established Paris Accord targets almost a decade ahead of schedule. The progress is largely attributable to government policy incentivizing the use of renewable energy sources as well as diminished reliance on fossil fuel sources. Evidencing such progress, electric vehicle sales in China jumped 70% in 2016 due to government tax incentives.

Despite the strides forward, pessimistic onlookers are more skeptical. Although China exceeded its carbon emissions targets, cynics argue that China must set more aggressive targets moving forward, as the country is the world's largest greenhouse gas emitter.

Notes:

1. CDS: Credit Default Swap
2. MSCI: An abbreviation for American index provider Morgan Stanley Capital International
3. MSCI Emerging Markets Index: A popular equity index with 829 large and mid-cap constituents across 23 emerging market (EM) countries.
4. USD: US Dollar, the official currency of the United States
5. QFII: Qualified Foreign Institutional Investor
6. RQFII: Renminbi Qualified Foreign Institutional Investor
7. ETF: Exchange Traded Fund
8. RMB: Renminbi, the official currency of China
9. CSI 300: A capitalization-weighted stock index designed to replicate the performance of the largest 300 equities traded in the Shanghai and Shenzhen stock exchanges in Mainland China. *One cannot invest directly in an index.*
10. G7: Group of 7 industrialized nations, comprised of the United States, United Kingdom, Germany, France, Italy, Japan, and Canada.